BEST PRACTICE

Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy (2003 and 2005) (DEBT)*

Background. The use of derivative products is becoming more prevalent in state and local governments' debt and risk management programs. A derivative is a financial instrument created from or whose value depends upon (is derived from) the value of one or more separate assets or indices of asset values. As used in public finance, derivatives may take the form of interest rate swaps, futures and options contracts, options on swaps and other hedging mechanisms such as caps, floors, collars and rate locks. Derivative products can be an important interest rate management tool that, when used properly, can increase a governmental entity's financial flexibility, provide opportunities for interest rate savings, alter the pattern of debt service payments, create variable rate exposure, change variable rate payments to fixed rate and otherwise limit or hedge variable rate payments.

Governmental issuers must learn about and understand the potential risks and rewards of derivative products in order to evaluate them properly as financing tools. Governmental issuers must understand fully the characteristics of derivative instruments, have the ability to determine a fair market price and be aware of the legal, accounting, credit and disclosure issues involved. These instruments should not be used for speculation, but only to manage risks associated with an issuer's assets or liabilities and only in conformance with financial policies that reflect the risk tolerances and management capabilities of the issuer.

Recommendation: The Government Finance Officers Association (GFOA) recommends that state and local officials to be cautious in the use of derivative instruments and to use them only when the officials have developed:

1. A sufficient understanding of the products. The GFOA encourages all financial officers to learn about the potential risks and benefits of using derivatives. A decision whether or not to use derivatives should be made on an informed basis. Training is essential both in evaluating the use of derivatives and in managing their use.

2. The internal staffing and expertise to manage and evaluate these products properly, either on their own or in combination with a swap or financial advisor. Government issuers must have in place:
    a. Methods for measuring, evaluating, monitoring and managing risks associated with derivative products, including:
        i. Basis risk – the mismatch between actual variable rate debt service and variable rate index used to determine swap payments. This risk can be managed through the creation of an interest rate reserve fund or conservative budgeting strategies.
        ii. Tax risk – the risk created by potential tax events that could affect swap payments. Careful attention should be paid to tax event triggers in the underlying swap documents.
        iii. Interest rate risk – how the movement of interest rates over time affects the market value of the instrument.
        iv. Counterparty risk – the failure of the counterparty to make required payments. This is particularly important if an issuer has more than one swap with a counterparty and the documents contain cross-default provisions. This can be addressed through the

establishment of ratings thresholds, guidelines for exposure levels and, particularly, collateralization requirements.

v. Termination risk – the need to terminate the transaction in a market that dictates a termination payment by the issuer. Market practice allows governmental issuers to limit the instances in which this can occur. This risk can also be mitigated through the identification of revenue sources for and budgeting of potential termination payments, structuring the swap so that bond proceeds can be used for termination payments and subordinating the lien status of potential payments.

vi. Market-access risk - the risk that a government will not be able to enter credit markets or that credit will become more costly. For example, to complete a derivative's objective, a new money issuance or a refunding may be planned in the future. If at that time the government is unable to enter credit markets, expected cost savings may not be realized while the issuer will continue to be subject to its obligations required by the derivative contract.

vii. Rollover or amortization risk - the mismatch of the maturity of the swap and the maturity of the underlying bonds or a mismatch in the amortization of the swap and bonds. This should be eliminated by making the maturity and amortization of the swap coterminous with those of the bonds.

viii. Credit risk – the occurrence of an event modifying the credit rating of the issuer or its counterparty. This should be addressed through minimizing cross defaults, the use of swap insurance and the favorable negotiation of credit event triggers in the underlying documentation.

b. Methods for selecting and procuring derivative products, including when competitive bids and negotiated transactions are warranted, and knowledge of pricing conventions and documentation standards.

c. Guidelines governing the proper disclosure of material information relating to executed derivative products to the issuer's governing body, in financial statements, to the rating agencies, to investors in connection with bond offerings, and to the municipal secondary market. Internal disclosure should include information about legal authority, risks, guidelines and market value. Official Statement disclosure should comport with current market practice.

d. Procedures and personnel responsible for internally managing and monitoring the issuer's (i) obligations (also known as operational risk), such as monitoring rates, calculating and making payments, managing collateral, and budgeting and accounting for derivatives appropriately and (ii) exposure, such as counterparty credit, collateral posting levels, variable rate exposure levels and basis risk. Pursuant to applicable accounting requirements, these procedures must include the development of a methodology for providing periodic termination value analyses.

3. A comprehensive derivatives policy. A derivatives policy should include:
    a. Evidence of clear legal authorization to enter into such arrangements and guidelines for how derivative products fit within the overall debt management program.
    b. A list of the types of derivative products that may be used or are prohibited.
    c. The conditions under which these types of products can be utilized (*i.e.* bidding procedures, minimum benefit thresholds, terms of master agreements).
    d. The maximum amount of derivatives contracts, or a means of determining such amount, *e.g.*, by reference to floating rate assets.
    e. Guidelines for selecting counterparties of high credit quality.

The GFOA recommends that all derivative transactions be documented using standardized forms, because standardized terms make it easier for market participants to analyze transactions, which minimizes costs. "Documentation in the municipal swap market is almost universally accomplished through the negotiation and execution of the forms of documents published by the International Swaps and Derivatives Associations, Inc. (ISDA)."[1] The GFOA also advises that many provisions in such forms are subject to negotiation and therefore

[1] National Federation of Municipal Analysts, *White Paper on Disclosure for Swaps* (February 2004)

recommends that finance officers have advisors familiar with such forms. Specifically, the provision of collateral by one or both parties to a swap under certain circumstances is determined at the time the swap is executed. The form of that potential collateral may also be decided at the point of execution or may be postponed until such collateral is required. Collateral is identified in a Credit Support Annex ("CSA"), and while it will add legal costs to the original transaction and has the potential of never being used, the GFOA recommends it be completed simultaneous with the execution of the swap to avoid having to negotiate collateral arrangements under distressed circumstances.

Once an issuer has adopted a derivatives policy and executed a derivatives transaction, the issuer should monitor and, to the extent possible, take action to limit its exposure to the risks described above. Because opportunities in the derivatives market change frequently, the GFOA encourages finance officers to keep abreast of such market conditions.

In September 2004, Standard & Poor's published its Debt Derivative Profile ("DDP"). The DDP outlines a rating process for municipal issuers of derivative products. According to the DDP, S&P will base each issuer's rating profile on four equally weighted components:

- Risk of termination or having to post collateral
- Counterparty credit quality and related contract termination risk
- Economic viability of derivative portfolio
- Management policies and procedures related to derivatives

S&P has indicated that the profile is a new process that may change over time. The other rating agencies currently incorporate their evaluations of issuers' derivatives exposures and safeguards into their credit ratings. It is recommended that issuers read and understand the most current material regarding the effect of derivatives on ratings prior to execution of a derivatives contract.

References

- *Swaps and the Municipal Market: The Impact of Swaps and FASB 133 on Municipal Credit Quality*, Moody's Investors Service, October 2002.
- GFOA Best Practice, "Debt Management Policy," *2003.*
- *Public Finance Criteria: Municipal Swaps,* Standard & Poor's, November, 2004.
- *Elected Official's Guide to Debt Issuance*, Patricia Tigue and J.B. Kurish, GFOA, 2005.
- "Understanding Municipal Derivatives," *Government Finance Review*, 2005.
- *Guidelines for Interest Rate Swaps and Variable-Rate Debt*, Fitch Ratings, 2005.

This Best Practice will be updated in 2010 and may change to be an Advisory.

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